

Tax Preferences for Sport Utility Vehicles (SUVs): Current Law and Legislative Initiatives in the 109th Congress

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Summary

The surge in domestic popularity of large sport utility vehicles (SUVs) since the early 1990s has stirred a debate over what steps the federal government should take, if any, to mitigate their effects on the environment, highway safety, traffic congestion, and U.S. dependence on foreign sources of oil. Legislative activity in the 108th Congress expanded the scope of the debate to include the ways in which the federal tax code encourages the purchase of heavy-duty SUVs, primarily for business use. In May 2003, Congress passed a measure (the Jobs and Growth Tax Relief Reconciliation Act of 2003) that raised the maximum expensing allowance under section 179 of the Internal Revenue Code (IRC) for these vehicles to \$100,000 from May 2003 through the end of 2005; the American Jobs Creation Act of 2004 lowered the allowance to \$25,000, as of October 22, 2004.

This report examines current federal tax preferences for SUVs and legislation in the 109th Congress that would alter them. It will be updated to reflect subsequent legislative activity addressing the preferences.

One way in which the federal tax code can influence the purchase of heavy-duty SUVs for business use is through the tax treatment of depreciation for these vehicles. Under current tax law, the depreciation of passenger cars is treated less generously than that of light trucks (including many SUVs). Passenger cars, which are defined as motor vehicles weighing 6,000 pounds or less, are considered so-called listed property—and thus subject to annual limits on depreciation allowances. By contrast, light trucks, which are defined as motor vehicles weighing more than 6,000 pounds (with some exceptions), are generally depreciated under a different and more favorable set of rules. For example, SUVs considered light trucks are eligible for a maximum expensing allowance of \$25,000 in the 2005 tax year, but the maximum first-year depreciation allowance in the same year for a passenger car under IRC section 280F is \$2,960. As a result, a business taxpayer can realize a greater reduction in the after-tax cost of a vehicle by purchasing a heavy-duty SUV instead of a passenger car of comparable value.

The federal tax code also encourages the purchase of heavy-duty SUVs by excluding them from the gas guzzler excise tax. The tax is levied on domestic sales of new automobiles with relatively poor fuel economy ratings. It is paid by manufacturers and importers. All light trucks, including all SUVs, are exempt from the tax.

Several legislative proposals in the 109th Congress would curtail the tax preference for heavy-duty SUVs embedded in current depreciation rules. Specifically, four bills—H.R. 4384, H.R. 4409, S. 1852, and S. 2025—would erase this preference by subjecting all SUVs with a gross weight of more than 6,000 pounds to 14,000 pounds to the annual depreciation limits for passenger cars under IRC section 280F. Two other bills—H.R. 2070 and S. 2345—take an indirect approach to lessening this tax preference.

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Americans have developed a love/hate relationship with sport utility vehicles (SUVs). Some view them as a symbol of profligate consumption and reckless disregard for highway safety, environmental protection, and fuel economy. For others, they represent a triumph of automotive engineering and design, one that is manifested in their unrivaled combination of ample storage space, enhanced passenger safety, towing capability, bold styling, and freedom to explore rugged terrain that is inaccessible for the average passenger car. In the decade ending in 2003, SUVs became a conspicuous presence on American roads, streets, and highways, as their sales and average size and weight steadily increased.

Although many SUV owners use them as they would a passenger car, there are some notable differences in design and performance between the typical SUV and the typical passenger car. Generally, SUVs tend to be taller and boxier. Many are built on the rigid chassis of a pick-up truck, giving them a relatively high clearance between the road surface and the undercarriage. Partly because SUVs tend to have a higher center of gravity than passenger cars, their ride feels bumpier and more like that of a truck, despite the availability of the same luxury options found in many automobiles. The increasing popularity of so-called crossover SUVs, which combine some of the attributes and looks of an SUV with the ride and handling of a passenger car, raises the possibility that over time the differences between the typical SUV and the typical passenger car will lessen.¹

Concern over the effects of SUVs on air quality, highway safety, and fuel consumption has spawned a continuing debate over whether the federal government should subject these vehicles to more stringent regulatory standards for safety and fuel economy. Legislative activity by the 108th Congress expanded the scope of debate to include the ways in which federal tax policy affects the demand for heavy-duty SUVs.

In passing the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA, P.L. 108-27), the 108th Congress hoped to achieve a variety of policy objectives, including faster growth in domestic business investment and job creation. Congressional debate over the measure gave no indication, however, that boosting domestic demand for heavy-duty SUVs was one of these objectives. Yet a provision in JGTRRA intended to stimulate small business investment in machinery and equipment (including most motor vehicles) and packaged software appeared to have such an effect. The provision made the expensing allowance under section 179 of the Internal Revenue Code (IRC) more generous in 2003 through 2005.

Not surprisingly, producers of heavy-duty SUVs and their dealers welcomed the stimulus. At the time JGTRRA was enacted, both parties were earning sizable profit margins on domestic sales of such vehicles.²

But not everyone was pleased that the newly enhanced expensing allowance applied to large SUVs. SUV critics labeled it an “SUV tax loophole” that would be likely to stimulate increased sales of the vehicles. To forestall such an outcome, they requested that the allowance be modified so that heavy-duty SUVs no longer qualified for it. According to critics, the federal government was not protecting or promoting the public interest by granting a tax subsidy for the purchase of motor vehicles intended for business use that, in their view, received poor gas mileage, emitted

¹ See Brett Clanton, “Large SUVs Lose Luster; Cost Big 3,” *Detroit News*, January 16, 2005, p. 1A; and Christine Tierney, “Party’s Over for Large SUVs as Tastes Shift,” *Detroit News*, December 9, 2005, p. 1A.

² See Robert Schoenberger, “Excursion May Get Stay of Execution; High Profit Margin Offsets Low Unit Sales,” *The Courier-Journal*, October 29, 2003, p. 1F.

high concentrations of air pollutants, and posed significant safety hazards to their own occupants and to passengers in other vehicles.³

Evidently, the 108th Congress paid attention to these objections, for it included a provision to curtail the preference in the final tax bill it passed, the American Jobs Creation Act of 2004 (AJCA, P.L. 108-357). Under the provision, the expensing allowance for SUVs not subject to the depreciation limitations for passenger cars under IRC section 280F was limited to \$25,000 for SUVs placed in service after October 22, 2004.

This report examines how the federal tax code treats the purchase of heavy-duty SUVs for business use and discusses proposals in the 109th Congress that would further change this treatment. Two statutory provisions make up the core of the report: the expensing allowance under IRC section 179 and the “gas guzzler” excise tax on domestic sales of new automobiles under IRC section 4064.

Domestic Demand for SUVs and the Debate Over Their Welfare Effects

Sport utility vehicles are classified as light trucks in existing data on domestic motor vehicle sales and production. In 2004, U.S. motor vehicles sales totaled 17.299 million units.⁴ Of that number, light trucks accounted for 54%, followed by passenger cars (43%) and medium and heavy trucks (2.5%). Sales of light trucks exceeded those of passenger cars for the first time in 2001. In 1992, by contrast, the share of passenger cars was nearly double that of light trucks: 63% to 35%.

Propelling the sharp rise in the light-truck share of domestic motor vehicle sales from the early 1990s through the early 2000s was the increasing popularity of SUVs. U.S. sales of SUVs jumped from less than 1 million units in the early 1990s to around 4.5 million units in 2003.⁵ Automobile manufacturers contributed to this growth by spending large sums on developing, producing, and marketing these vehicles.⁶ As one might expect, this investment was driven by the prospect of reaping substantial profits. In 1998, the Ford Motor Company reportedly earned about \$2.4 billion in after-tax profits from sales of just two of its SUV lines, the Expedition and Navigator.⁷ An analyst estimated that an SUV with a 2003 sticker price of \$50,000 might yield a profit of \$20,000 or more, whereas the profit on a minivan would be about one-tenth as much.⁸

Growth in domestic sales of SUVs appears to have slackened in both 2004 and 2005, though a lack of data from public sources makes it difficult to gauge the extent of the slowdown. During that period, what might be described as a growing split emerged within the domestic SUV market between full-size or heavy-duty SUVs and crossover SUVs. Sales of the former have been falling,

³ See Aileen Roder and Lucas Moinester, “A Hummer of a Tax Break,” *Taxpayers for Common Sense* (Washington: January 23, 2003); Pamela Najor, “Tax Cut Bill ‘Bad Policy’, Group Says, Creating Perverse Incentives for SUVs,” *Daily Report for Executives* (Washington: Bureau of National Affairs, May 28, 2003), p. G-7; and “Make Fuel-Efficient SUVs a Go, But Stop Tax Break,” editorial, *Atlanta Journal-Constitution*, October 27, 2003, p. 10A.

⁴ Standard & Poor’s, *Industry Surveys: Autos & Auto Parts* (New York: December 22, 2005), p. 3.

⁵ Brett Clanton, “SUV Glut Signals Dip in Interest,” *Detroit News*, August 13, 2004, p. A1.

⁶ Spending on SUV advertising in the United States rose from \$172.5 million in 1990 to \$1.51 billion in 2000. See Keith Bradsher, *High and Mighty* (New York: Public Affairs, 2002), p. 112.

⁷ *Ibid.*, p. 89.

⁸ Jonathan Weisman, “Businesses Jump on an SUV Loophole; Suddenly \$100,000 Tax Deduction Proves a Marketing Bonanza,” *Washington Post*, November 7, 2003.

while sales of the latter have been rising. In 2005, for example, U.S. purchases of large SUVs were 13.1% below the level in 2004, whereas purchases of crossover SUVs increased 13.5%.⁹ A variety of factors explain the drop in sales of full-size SUVs. Foremost among them are the advanced age of the design of the current crop of large SUVs, and changing tastes among car buyers—driven partly by a rising concern about excessive energy consumption and the upward spike in gasoline prices in 2004 and 2005. Nonetheless, at least one market research firm, J.D. Power and Associates, is predicting a rebound in domestic sales of large SUVs in 2006 and 2007 to levels seen in 2001 to 2003, driven by the advent of new models of full-size SUVs offering improved fuel economy.¹⁰

The enormous growth in domestic ownership of SUVs since the early 1990s has fueled a lively debate over their effects on highway safety, air quality, and U.S. reliance on foreign sources of crude oil and petroleum products, among other concerns.¹¹ Critics charge that SUVs, especially the full-size models, wastefully consume gasoline, contribute more to air pollution and global warming than passenger cars, and pose a significant threat to the safety of their own passengers—as well as other people on the road. Owners of the vehicles retort that large SUVs offer greater protection to passengers than do smaller vehicles and are much safer than critics contend. They also argue that in a democratic society with a free-market economy, consumers should be allowed to own heavy-duty motor vehicles if they value personal safety more than gas economy.

Sorting fact from fiction in the debate about the welfare effects of SUVs can be a challenge. A careful review of the literature on these effects reveals that SUVs have accounted for an increasing share of total fuel consumption and emissions by motor vehicles in the past decade or so. On average, their gas mileage has been lower, their emissions of carbon monoxide and nitrogen oxides higher, and their risk of rolling over in an accident greater than most passenger cars.¹² In addition, compared to passenger cars, SUVs face less stringent federal standards for fuel economy and emissions, and their safety record is thought to receive less scrutiny from federal agencies.¹³ But several public announcements in recent years by both federal regulatory agencies and manufacturers of SUVs hold the promise that these discrepancies might shrink or disappear in coming years.¹⁴

⁹ Karen Lundegaard, "A New Generation of SUVs; Sales of 'Crossovers' Expected to Outstrip SUVs This Year; Latest Models Get Wider and Longer," *Wall Street Journal*, January 10, 2006, p. D1.

¹⁰ Standard & Poor's, *Autos & Auto Parts*, p. 10.

¹¹ For an overview of the principal arguments made by proponents on both sides of this debate, see Cooper, "SUV Debate," pp. 451-461; Gregg Easterbrook, "America's Twisted Love Affair With Sociopathic Cars," *New Republic*, vol. 228, January 20, 2003, pp. 27-34; and Sam Kazman, "Is Big Bad?: SUV Critics Hold Consumers in Contempt," *Reason*, August/September 2003, available at <http://www.cei.org>.

¹² Cooper, "SUV Debate," pp. 453-458.

¹³ See Cooper, "SUV Debate," p. 454; and CRS Report RS20298, *Sport Utility Vehicles, Mini-Vans, and Light Trucks: An Overview of Fuel Economy and Emissions Standards*, by Brent D. Yacobucci.

¹⁴ The Environmental Protection Agency issued a final rule in February 2000 that beginning with the 2009 model year (MY), all light trucks, including SUVs, will be held to the same emissions standards as passenger cars (see 65 Federal Register 6698, February 10, 2000).

In addition, in December 2002, the National Highway Traffic Safety Administration (NHTSA) proposed that starting with MY2005, all light trucks, including SUVs, will be subject to higher fuel economy standards. Under the rule, their average fuel economy would rise from the current requirement 20.7 miles per gallon (mpg) to 21.0 mpg in MY2005, 21.6 mpg in MY2006, and 22.2 mpg in MY2007 (see 67 Federal Register 77015-77029, December 16, 2002). NHTSA announced in April 2003 that the rule had been adopted.

On March 29, 2006, NHTSA released a final rule setting new and higher fuel economy standards for light-duty trucks in the model years from 2008 to 2011. Under the rule, the current corporate average fuel economy (CAFÉ) standards for light trucks are revised so that they cover vehicles (including SUVs) weighing up to 10,000 pounds; the previous

Depreciation of Motor Vehicles Under the Federal Tax Code

A logical starting point for an examination of how the federal tax code affects the purchase of heavy-duty SUVs is the tax treatment of depreciation for motor vehicles in general and passenger cars in particular. Within this treatment lies the most important tax subsidy for the purchase of these SUVs for business use. It is difficult to comprehend the nature of this subsidy without having a good grasp of the current rules for recovering the cost of motor vehicles bought mainly for business use.

In general, business taxpayers—C corporations, shareholders of S corporations, members of partnerships and limited liability corporations, and sole proprietors—are allowed to deduct all ordinary and necessary expenses they incur in determining their taxable income in a particular tax year. One such expense is depreciation, which represents the decline in the economic value of tangible and intangible business assets resulting from wear and tear and obsolescence. Under current tax law, the cost of a depreciable asset such as a building, patent, light truck, or machine tool is recovered over a specified period (known as the asset's tax life) using an allowable method of depreciation (e.g., the straight-line or double-declining balance methods).¹⁵ This period may or may not match an asset's actual useful life, which is often difficult to gauge.

Usually in a bid to spur increased business investment, governments sometimes permit business taxpayers to recover the cost of specified depreciable assets well before their economic value has been exhausted. Such an acceleration in the rate of depreciation for tax purposes encourages firms to invest more in the favored assets than they otherwise would, setting the stage for faster economic growth in the short term. But the economic gains arising from accelerated depreciation often come with significant economic costs. Specifically, such depreciation distorts the allocation of economic resources by encouraging investment in favored assets at the expense of other assets offering higher pre-tax rates of return on investment, and into industries that intensively use the

standards applied to light trucks that weighed up to 8,500 pounds. Pickup trucks weighing more than 8,500 are exempt from the new standards. The new standards depend on a vehicle's size, as measured by its so-called footprint, which is the product of multiplying the vehicle's wheelbase by its track width. Light trucks with smaller footprints have higher standards than larger footprints. Manufacturers of light trucks have the choice of complying with the revised CAFE standards or the previous standards during the transition period of MY2008 to MY2010. Starting in MY2011, all manufacturers must comply with the revised standards.

Finally, in early December 2003, 15 automobile makers from four nations voluntarily agreed to redesign the SUVs and pick-up trucks they sell in the United States to make them less dangerous to the occupants of passenger cars. The announced design changes are to be phased in so that all MY2010 light trucks will incorporate them. Many of the largest SUVs and pick-up trucks sold domestically will need to be redesigned. Because the action is being taken voluntarily, it is unclear what role federal regulatory agencies will play in the redesign effort. (See Danny Hakim, "Automakers to Redesign S.U.V.'s to Reduce Risks," *New York Times*, December 4, 2003, p. A1; and Lorrie Gilbert, "Automakers Announce Plans to Improve Designs for Vehicle Occupant Protection," *Daily Report for Executives*, Bureau of National Affairs, December 5, 2003, p. A-37.)

¹⁵ Generally, most depreciable tangible assets placed in service after 1986 are depreciated under a system known as the Modified Accelerated Cost Recovery System (MACRS). Under MACRS, the cost of an asset is recovered by applying the proper depreciation method, the proper recovery period, and the proper convention. A taxpayer may choose to use the straight-line method, which involves writing off the same amount of the asset's acquisition cost in each year of its recovery period; its basic rate is equal to one divided by the number of years in the recovery period. Otherwise, the cost of assets in the 3-, 5-, 7-, and 10-year classes is recovered using the 200% or double-declining balance method. Under this method, the basic rate of depreciation is simply twice that of the straight-line method. The cost of assets in the 15- and 20-year classes is recovered using the 150% declining balance method, whose basic rate is 1.5 times larger than that of the straight-line method. Longer-lived assets must be depreciated using the straight-line method.

tax-favored assets at the expense of other industries where pre-tax rates of return on investment may be higher. Accelerated depreciation has these unwanted efficiency effects mainly because it lowers the user cost of capital for investment in favored assets relative to the user cost of capital for investment in other assets, all other things being equal.

The cost of most tangible depreciable business assets placed in service after 1986 is recovered under what is known as the Modified Accelerated Cost Recovery System (MACRS). Under this system, which was put in place by the Tax Reform Act of 1986 (P.L. 99-514), new and used automobiles and light trucks (including SUVs, vans, and minivans) used primarily in a trade or business are assigned a recovery period of five years. Their cost may be recovered under any of the allowable depreciation methods, the most advantageous of which is the double-declining balance method. Nevertheless, as is explained below, an exception to this treatment is made for passenger cars used primarily in a trade or business that are regarded as luxurious under the federal tax code.

Except for luxury passenger cars, the cost of motor vehicles bought mainly for business use may also be expensed under section 179 of the Internal Revenue Code (IRC).¹⁶ Generally, expensing involves writing off or deducting the full cost of a depreciable asset in the year when it is placed into service, regardless of the asset's useful life. As a result, expensing is the most accelerated form of depreciation. Owing to changes in section 179 made by JGTRRA and AJCA, business taxpayers may expense in a single tax year more than \$100,000 of the cost of qualified assets placed in service from 2003 through 2007.¹⁷ Before JGTRRA, the maximum expensing allowance in that period was set at \$25,000. With a few minor exceptions, qualified assets are defined as new and used business machines and equipment (including most motor vehicles) and packaged or off-the-shelf software used in the active conduct of a trade or business. The amount that a business taxpayer may expense is subject to two important limitations: a dollar limitation and an income limitation. Under the dollar limitation, the maximum expensing allowance is reduced, dollar for dollar, by the amount by which the total cost of qualified property placed in service in a tax year exceeds a phase-out threshold of more than \$400,000 from 2003 through 2007.¹⁸ The threshold was fixed at \$200,000 in that period before the enactment of JGTRRA. Under the income limitation, the expensing allowance cannot exceed the taxable income a taxpayer earns from the active conduct of the trade or business in which the qualified assets are employed. Assuming no change in current law, the maximum expensing allowance will revert to \$25,000 and the phase-out threshold to \$200,000 in 2008 and beyond.

The expensing allowance is regarded as an investment tax subsidy for smaller firms for a simple reason: the phase-out threshold effectively restricts use of the allowance to firms that are relatively small in asset, employment, or revenue size.

In addition, new (but not used) motor vehicles used primarily in a trade or business were among the business assets that qualified for temporary first-year depreciation deductions of 30% under the Job Creation and Worker Assistance Act of 2002 (JCWAA, P.L. 107-147) and 50% under JGTRRA. The 30% deduction applied to qualified property acquired after September 10, 2001,

¹⁶ For more details on the expensing allowance, see CRS Report RL31852, *Small Business Expensing Allowance: Current Status, Legislative Proposals, and Economic Effects*, by Gary Guenther.

¹⁷ This amount is indexed for inflation in 2004 through 2007. As a result, the maximum expensing allowance for firms operating outside enterprise and empowerment zones and other designated areas was \$102,000 in 2004 and \$105,000 in 2005.

¹⁸ This amount is also indexed for inflation in 2004 through 2007. As a result, the phase-out threshold for firms operating outside enterprise and empowerment zones and other designated areas was \$410,000 in 2004 and \$420,000 in 2005.

and before January 1, 2005, and placed in service before January 1, 2005;¹⁹ the 50% deduction applied to the same set of assets acquired after May 5, 2003, and before January 1, 2005, and placed in service before January 1, 2005. Business taxpayers could claim either deduction, but not both. In effect, they operated as partial expensing allowances, and firms of all asset, employment, or revenue sizes and forms of legal organization were able to benefit from them.

Although the depreciation of motor vehicles in general is governed by the rules of the MACRS and the expensing allowance, the cost of so-called luxury passenger cars used primarily for business is recovered under a different set of rules. More specifically, the depreciation allowances for those cars are subject to annual limits under IRC section 280F, limits that may extend the tax life of a passenger car far beyond five years. This statutory provision, which entered the federal tax code through the Deficit Reduction Act of 1984 (P.L. 98-369), establishes a separate category of tangible depreciable assets known as listed property. In general, listed property embraces assets whose nature or purpose makes it possible to use them for both business and personal purposes. Under current law, passenger cars and other transportation equipment; property used in entertainment, recreation, or amusement; computers and peripheral equipment; and cellular telephones and similar telecommunications equipment are considered listed property. There are specific dollar limits on the depreciation allowances that may be claimed for each type of listed property in a single tax year, assuming business use accounts for 50% or more of total use of the property.²⁰ If business use accounts for 100% of a listed property's use, then the maximum depreciation allowance may be claimed for a tax year. But if business use represents less than 100% of the property's use, then the depreciation allowance must be adjusted to reflect the business share of total use.²¹

In the case of luxury passenger cars, the limits under IRC section 280F represent the maximum depreciation deductions that may be claimed under a combination of the MACRS, the IRC section 179 expensing allowance, and the temporary 30% and 50% first-year depreciation deductions established by JCWAA and JGTRRA (if applicable). For example, a business taxpayer may claim a maximum first-year depreciation allowance of \$10,610 (if he or she claims the 50% bonus depreciation) for a new passenger car placed in service in 2004; the maximum first-year allowance falls to \$2,960 for a new passenger car placed in service in 2005, when the bonus depreciation no longer was available.²² Higher limits apply to electric passenger vehicles built by an original equipment manufacturer and placed in service after August 5, 1997, and before January 1, 2007: the maximum first-year allowance for such a vehicle placed in service in 2005 is \$8,880.

¹⁹ The 30% and 50% temporary depreciation allowances were available for new assets that were depreciable under the MACRS and had recovery periods of 20 or fewer years. They also applied to water utility property, computer software that was depreciable over three years under IRC Code 167, and qualified leasehold improvements.

Some property can be placed in service in 2005 still qualify for the allowances. Specifically, the property must be produced by a business taxpayer and subject to the uniform capitalization rules under IRC Section 263A, have a production period of more than two years or more than one year and a cost exceeding \$1 million, and have a recovery period under the MACRS of at least 10 years or be used in the business of transporting people for hire.

²⁰ If business use of listed property drops below 50% of total use, the property must be depreciated under the MACRS alternative depreciation system (ADS), which tends to be much less generous than the regular MACRS. Property whose cost is recovered under the ADS is not eligible for the 30% or 50% temporary first-year depreciation allowances under JCWAA and JGTRRA, respectively.

²¹ For example, if the business share of total use for a passenger car is 75%, then the depreciation deduction that may be claimed in a particular tax year is 75% of the maximum allowed under IRC section 280F.

²² See IRS Revenue Procedure 2005-13.

The limits went into effect in 1984 and have been adjusted for inflation since 1988. Although their original intent was to discourage the purchase of expensive cars for business use, the limits no longer effectively serve this purpose because they have not kept pace with increases in the cost and improvements in the quality and design of passenger cars.²³ The federal tax code does not define a luxury passenger car; instead, the worth of such a vehicle is determined on the basis of the total depreciation allowances under IRC section 280F during the first five years a passenger car is used for business purposes. For example, any passenger car placed in service in 2005 whose purchase price was \$13,860 or more was deemed a luxury car under IRS regulations.

Depreciation of SUVs Under the Federal Tax Code

The tax treatment of depreciation for an SUV hinges on the vehicle's weight and design. Depending on its weight and the type of chassis upon which it is built, an SUV may be classified—for tax purposes—as either a passenger car or a light truck. This distinction is hardly trivial, as it can affect the number of tax years required to recover the cost of an SUV and the after-tax cost of the vehicle.

As discussed in the previous section, current federal tax law imposes annual limits on depreciation allowances for luxury passenger cars. The tax code defines passenger cars as four-wheeled vehicles built on a car chassis and made primarily for use on public streets, roads, and highways and having an unloaded gross vehicle weight (i.e., curb weight fully equipped for service but without passengers or cargo) of 6,000 pounds or less. Under this definition, trucks, vans, minivans, and SUVs built on an automobile chassis with a gross vehicle weight (i.e., maximum total weight of a loaded vehicle as specified by the manufacturer) of 6,000 pounds or less should be subject to the same depreciation limits as passenger cars. But this is not the case for all such vehicles. Trucks (including SUVs) and vans placed in service after July 7, 2003, weighing 6,000 pounds or less, and built on a car chassis are exempt from the depreciation limits for passenger cars *if they satisfy the requirements for a “qualified personal use vehicle.”* Such a vehicle is defined as a truck or van that has been modified in such a way that it is unlikely to be used for personal purposes. Examples of such vehicles are marked police or fire vehicles, delivery trucks with seating only for the driver, flatbed trucks, and refrigerated trucks.²⁴ A different set of depreciation caps under IRC section 280F applies to light trucks (including SUVs), minivans, and vans weighing 6,000 pounds or less built on a truck chassis and placed in service after 2002.²⁵ These caps are higher than the ones for passenger cars: for such a light truck placed in service in 2005, the maximum first-year depreciation allowance is \$3,260, compared to a first-year allowance of \$2,960 for passenger cars.

SUVs, trucks, vans, and minivans built on a truck chassis with a gross vehicle weight of more than 6,000 pounds are considered light trucks for tax purposes and thus exempt from the depreciation limitations for luxury passenger cars under IRC section 280F.²⁶ The exemption

²³ See U.S. Congress, Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, JCS-41-84 (Washington: GPO, 1985), pp. 559-560.

²⁴ See Temporary Reg. §1.275-5T(k). Under temporary rules (T.D. 9069) issued by the Internal Revenue Service on July 7, 2003, certain vans and light trucks weighing 6,000 pounds or less have not been treated as passenger cars for tax purposes since the 2003 tax year. More specifically, the exclusion applies to vans and light trucks that are modified for business use in a way that precludes any personal use. The rules were issued in response to numerous complaints from small business owners that current dollar limits on depreciation deductions for passenger cars were making it impossible to write off the cost of a basic model van or light truck in the five years permitted under MACRS.

²⁵ See IRS Revenue Procedure 2003-75.

²⁶ SUVs belonged to this category of vehicles before the enactment of the American Jobs Creation Act of 2004.

originated with the Deficit Reduction Act of 1984 and was initially intended to allow owners of heavy-duty working vehicles used in farming or construction or other trades or businesses to recover the cost of these vehicles much faster than would be possible under IRC section 280F. Business taxpayers owning vehicles eligible for the exemption can recover their cost under the regular depreciation rules for motor vehicles. This means, in the case of a business owner who bought a light truck and placed it in service in 2005, that the owner may claim a depreciation allowance based on the rules of the IRC section 179 expensing allowance and the MACRS. As noted above, small business owners, including self-employed individuals, are the taxpayers most likely to claim the expensing allowance.

A provision of AJCA modified IRC section 179 to limit the expensing allowance that may be claimed for SUVs built on a truck chassis with a gross vehicle weight of more than 6,000 pounds. Specifically, it limits the amount of the cost of SUVs with a gross vehicle weight of more than 6,000 pounds and less than 14,000 pounds that may be expensed to \$25,000.²⁷ This limitation applies to vehicles placed in service after October 22, 2004. Under the provision, SUVs are defined as any four-wheeled vehicle designed mainly “to carry passengers over public streets, roads, or highways” that are exempt from the depreciation caps under IRC section 280F and whose gross vehicle weight does not exceed 14,000 pounds. Because this definition could apply to many pickup trucks, vans, and small buses, the provision further refines it so that many of these vehicles are eligible for the regular expensing allowance of over \$100,000.²⁸ Despite this refinement, it appears that pickup trucks with a cargo bed of less than six feet and weighing more than 6,000 pounds and most passenger vans weighing more than 6,000 pounds are subject to the \$25,000 limit.

Accelerated Depreciation and Demand for Heavy-Duty SUVs

How does the current tax treatment of depreciation for motor vehicles affect domestic demand for SUVs? This question cannot be answered with precision because of the many factors that influence sales and the difficulty of isolating the effects of a single factor. Nonetheless, there is no question that current depreciation rules favor the purchase of heavy-duty SUVs over lighter SUVs or passenger cars of comparable value. Supporting evidence can be found in the greater tax benefit to business taxpayers from buying an SUV exempt from the depreciation caps on luxury passenger cars than from buying a vehicle subject to those caps. This added benefit stems from the accelerated depreciation for heavy-duty SUVs available under IRC section 179. The allowance for these vehicles expanded under JGTRRA but contracted under AJCA to what it was when JGTRRA was enacted.

²⁷ Under JGTRRA, the maximum expensing allowance for SUVs weighing more than 6,000 pounds was not less than \$100,000. So any such SUV bought and placed in service from January 1, 2004, through October 22, 2004, was eligible for that allowance. AJCA reduced it to the amount that was in effect in 2003 before the enactment of JGTRRA.

²⁸ The following vehicles are excluded from the definition of SUVs under IRC Section 179(b)(6)(B)(i) and thus not subject to the limitation it imposes on the expensing allowance for heavy-duty SUVs: (1) those designed to have a seating capacity of more than nine persons behind the driver’s seat; (2) those equipped with a cargo area of at least six feet in length that is an open area and is not readily accessible from the passenger compartment; (3) those equipped with a cargo area of at least six feet in interior length that is designed for use as an open area but is enclosed by a cap and is not readily accessible directly from the passenger compartment; and (4) those with an integral enclosure spanning the driver compartment and load-carrying device, no seating behind the driver’s seat, and no body section protruding more than 30 inches ahead of the leading edge of the windshield.

The figures in **Table 1** illustrate the greater tax benefit from purchasing a large SUV for business use. It can be seen in a comparison of the maximum first-year depreciation deductions and the present value of total depreciation allowances (in 2005 dollars)—and the present value of the tax savings associated with these allowances—a non-corporate business taxpayer is allowed to claim as a result of placing in service in 2005 a new SUV weighing over 6,000 pounds but not more than 14,000 pounds, or a new passenger car of equal value.²⁹ The comparisons are made under the depreciation rules that were in effect both before and after the enactment of AJCA. In computing the depreciation deductions, it is assumed that each vehicle is driven solely for business purposes, the taxpayer earned at least \$40,000 in 2005 from the trade or business in which the vehicle is used, and the double-declining balance method of depreciation with the half-year convention is used. In computing the present value of the total depreciation allowances claimed for each vehicle and the associated tax savings, it is further assumed that the discount rate is 4.3, which was the average rate for 10-year Treasury bonds in 2005.

Table 1. First-Year Depreciation Deductions and Present Value of Total Depreciation Deductions and Total Tax Savings for a Large SUV and a Passenger Car Placed in Service in 2005

Vehicle	New Heavy-Duty SUV		New Passenger Car
Assumed Curb Weight (pounds)	6,400		3,200
Purchase Price	\$40,000		\$40,000
Maximum First-Year Depreciation Allowance ^a	Under the American Jobs Creation Act of 2004 ^b	Under the Jobs and Growth Tax Relief Reconciliation Act of 2003 ^c	\$2,960
	\$28,000	\$40,000	
Years Required to Recover the Acquisition Cost ^d	6	1	21
Present Value of Total Depreciation Deductions (2005 dollars) ^e	\$37,327	\$38,351	\$27,638
Present Value of Total Tax Savings (2005 Dollars) ^e	13,064	13,423	9,670
After-Tax Cost of the Vehicle ^f	26,936	26,577	30,330

Source: Congressional Research Service

- a. The passenger car is subject to annual limits on depreciation deductions under IRC Section 280F. The SUV is not subject to any such limits and thus is eligible for the maximum expensing allowance allowed under IRC section 179, and the regular depreciation allowance under the MACRS.
- b. The figures in this column reflect the current limit of \$25,000 on the maximum expensing allowance in a single tax year for an SUV with a gross vehicle weight of over 6,000 pounds but less than 14,000 pounds. This limit was established by the American Jobs Creation Act of 2004.

²⁹ Comparing first-year depreciation allowances offers a useful frame of reference because the tax savings caused by accelerated depreciation depends on the proportion of an asset's acquisition cost recovered in the first year or two of its tax life. These benefits increase as the proportion expands and a depreciable asset's tax life shrinks. The fundamental reason lies in the time value of money and the tax deferral made possible by accelerated depreciation: tax savings realized today are more valuable than the same amount of tax savings realized over five or 10 years.

- c. The figures in this column reflect the limit of \$102,000 on the maximum expensing allowance in 2004 for SUVs with a gross vehicle weight of more than 6,000 pounds. This limit was in effect before the enactment of the American Jobs Creation Act of 2004.
- d. According to IRS Revenue Procedure 2005-13, the maximum depreciation allowance in 2005 for a passenger car placed in service that year was \$2,960, followed by \$4,700 in 2006, \$2,850 in 2007, and \$1,675 in each succeeding year. The SUV is depreciated using the double-declining balance method with a half-year convention.
- e. In estimating the present value of total depreciation allowances, it is assumed that the discount rate is 4.3%.
- f. The purchase price less the present value of the tax savings from the depreciation allowances.

The results imply that a business owner would realize a higher after-tax return on investment—and perhaps a greater cash flow in the short run—by purchasing the SUV instead of the passenger car. Such an inference is warranted because of the differences in the present value of total allowable depreciation deductions and the present value of the associated tax savings among the three cases. In general, the greater the present value of these deductions, the greater the tax savings from purchasing a depreciable asset; and the greater the tax savings, the lower the tax burden on the returns to investment in the asset. These savings lower the effective price of a depreciable asset.³⁰ The present value (in 2005 dollars) of total depreciation allowances for the SUV under JGTRRA (\$40,000) is 45% greater than the present value of depreciation allowances for the passenger car; and the present value for the SUV under current law is 35% greater than that for the passenger car. Although the buyer eventually recovers the acquisition cost of each vehicle, the passenger car yields the lowest tax savings (in current dollars) because it takes 20 years more than the SUV under JGTRRA and 15 years longer than the SUV under current law to recover that cost.

Some may find it surprising that there is only a 7% difference between the present value of total depreciation allowances for the SUV under current tax law and the present value of depreciation allowances under JGTRRA. After all, AJCA reduced the maximum expensing allowance for heavy-duty SUVs from over \$100,000 to \$25,000. If anything, this result suggests that the decrease in the maximum expensing allowance for heavy-duty SUVs under AJCA did little to curtail the tax preference for buying these vehicles under current depreciation rules.

Is there any evidence that the tax preference for heavy-duty SUVs under current depreciation rules has boosted their domestic sales? What evidence is available from public sources seems inconclusive. On the one hand, domestic sales of full-size and luxury SUVs exhibited surprising strength in December 2003 and January 2004, and some analysts ascribed this strong showing, in part, to the availability of the \$100,000 expensing allowance, heightened efforts by dealers to make customers aware of it through local advertising campaigns, and the widespread belief that Congress would act soon to eliminate or curtail this tax preference.³¹ On the other hand, U.S. sales of the heaviest SUVs declined by 6% in 2004 compared to 2003, even though for more than 10 months of the year the maximum expensing allowance for the vehicles was \$102,000.³²

The decision to purchase a motor vehicle mainly for business use obviously hinges on more factors than the tax treatment of its depreciation. Of particular importance in the case of small business owners are the income and tastes of the buyer; the current price of gasoline and expected trends in this price in coming years; and the cost, gas mileage, safety features, and repair record of the vehicles being considered. Assessing the effect of a change in depreciation rules on

³⁰ See Harvey S. Rosen, *Public Finance*, 7th ed. (New York: McGraw-Hill Irwin, 2005), p. 432.

³¹ See Jim Hopkins, "SUV Sales Climb on Tax Loophole; Small Businesses Discover Benefit," *USA Today*, February 11, 2004, p. B3.

³² Brett Clanton, "Large SUVs Lose Luster, Cost Big 3," *Detroit News*, January 16, 2005, available at <http://www.detnews.com>.

domestic sales of a motor vehicle when some or all of the other important factors affecting sales trends are changing at the same time is a difficult challenge. Nonetheless, it seems reasonable to assume that domestic demand for heavy-duty SUVs is greater than it would be if the tax code were to treat the depreciation of these vehicles and passenger cars in the same manner. What is uncertain is how much greater.

Public policy in a variety of areas—especially energy use, taxation, environmental protection, highway safety, and oil import dependence—could benefit from a study that evaluates the extent to which the tax preference for large SUVs embedded in the depreciation rules boosts domestic demand for them, and the social costs and benefits of the added sales attributable to the preference.

Gas Guzzler Excise Tax

The tax treatment of depreciation for heavy-duty SUVs is not the only way in which the federal tax code encourages the purchase of these vehicles. IRC section 4064, which levies an excise tax on domestic sales of new automobiles that do not meet statutory fuel economy standards, may offer small business owners (and other consumers) another incentive to prefer heavy-duty SUVs to motor vehicles that are more efficient in fuel consumption. This tax is known as the gas guzzler tax.

The gas guzzler tax originated with the Energy Tax Act of 1978 (P.L. 95-618), and the IRS issued the first regulations to implement it in 1980. It applies to domestic sales of automobiles by manufacturers and importers, who are required to pay the tax. IRC section 4064(b) defines an automobile as any “four-wheeled vehicle propelled by fuel which is manufactured primarily for use on public streets, roads, and highways.” Until the passage of the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU, P.L. 109-59) in August 2005, the definition of automobiles also stipulated that such vehicles have an unloaded gross vehicle weight of 6,000 pounds or less; the act repealed this weight limitation, subjecting all vehicles meeting the remaining criteria for an automobile to the tax, irrespective of their weight. Certain vehicles are exempt from the tax: namely, emergency vehicles such as ambulances and police cars, cars with a gas mileage rating of 22.5 miles per gallon (mpg) and over, and all light trucks (including SUVs of all weights). Whether a gas guzzler tax is owed—and if so, the amount of the tax—depends on an automobile’s combined city and highway fuel economy rating, which is defined as the average number of miles traveled by an automobile per gallon of gasoline as determined by the Environmental Protection Agency. The current tax ranges from \$1,000 for cars with a fuel economy rating of at least 21.5 miles per gallon but less than 22.5 miles per gallon to \$7,700 for cars with a rating of less than 12.5 miles per gallon. These amounts have been in effect since the enactment of the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508). In FY2004, the tax raised \$141 million in revenue, up from \$71 million in FY2000.

The tax arguably serves two intertwined policy goals. It promotes the development, manufacture, and sale of fuel-efficient cars by raising the average cost of producing cars subject to the tax relative to that of cars exempt from the tax. At the same time, the tax mitigates the negative external effects of driving relatively fuel-inefficient cars. Prominent among these effects is the added air pollution from driving such vehicles. To the extent that the burden of the gas guzzler tax is borne by manufacturers and importers, it compels them to pay for some of these costs.

The Gas Guzzler Tax and the Demand for Heavy-Duty SUVs

As noted above, the gas guzzler tax does not apply to SUVs. As a result, demand for heavy-duty SUVs is likely to be greater than it would be if they were subject to the tax and buyers were forced to bear its burden. Since most heavy-duty SUVs get relatively low gas mileage, retail prices could be as much as \$4,500 to \$7,700 higher for many models if current law were changed to subject them to the tax and importers, manufacturers, and dealers were to pass the full amount of the tax on to buyers.

It appears that considerable revenue could be raised by modifying the tax so that it applies to all light trucks (including SUVs). According to one estimate, the U.S. Treasury lost about \$10 billion in revenue in 1999 because of the exemption of light trucks from the tax.³³ Domestic sales of these vehicles totaled 9.4 million units in 2004, or 1.2 million units more than the total for 1999. Unfortunately, the data needed to estimate the additional revenue that would have been raised if the tax had applied to all light vehicles sold in the United States in 2004 are not available from public sources and would be costly to obtain from private sources.

How would domestic demand for heavy-duty SUVs be likely to respond to the imposition of the gas guzzler tax? The answer hinges on the extent to which buyers end up bearing the burden of the tax and the sensitivity of demand for those vehicles to increases in retail prices. Although manufacturers and importers would be required to pay the tax, there is no certainty that they would bear the entire burden by accepting declines in the profits they earn from domestic SUV sales. Rather, they would be likely to try to shift at least part of the tax to some combination of employees (through lower compensation), suppliers of materials, parts, and components (through lower prices), and buyers of heavy-duty SUVs (through higher retail prices). The distribution of the burden between manufacturers and importers on the one hand and buyers on the other hand ultimately hinges on the price sensitivity (or elasticity) of demand and supply for heavy-duty SUVs. To maintain their profit margins on sales of heavy-duty SUVs, manufacturers would want to pass the entire amount of the tax on to buyers, but their resolve to do so would be constrained by the prospect of losing large numbers of buyers in response to an increase in prices because of the tax. In general, producers are more likely to bear most of the burden of a tax like the gas guzzler excise tax if demand is more sensitive to price changes than supply in the short run; but consumers are more likely to bear most of the burden if demand is less sensitive to price changes than supply in the short run. The data needed to estimate these sensitivities for heavy-duty SUVs are not available from public sources and would be costly to obtain from private sources.

Legislative Initiatives in the 109th Congress to Curtail or Eliminate SUV Tax Preferences

Several bills to curtail—directly and indirectly—current tax preferences for heavy-duty SUVs have been introduced in the 109th Congress. It is uncertain whether any of them will receive attention from the full House or Senate in coming months. Efforts to curtail the preferences might

³³ A 2000 study issued by the environmental advocacy group Friends of the Earth concluded that domestic and foreign automobile manufacturers avoided paying \$10.2 billion in gas guzzler excise taxes in 1999 and \$43.1 billion from 1995 through 1999 because of the exemption of light trucks from the tax. It is not clear from the study what assumptions were made in arriving at this estimate. See Friends of the Earth, *Gas-Guzzler Loophole: SUVs and Light Trucks Drive Off with Billions* (Washington: 2000), available at <http://www.foe.org>.

encounter opposition from the automobile industry and its allies in Congress. In light of the current federal budget deficit and the prospect of larger deficits in the future, a key issue in congressional consideration of any of these measures will be its likely revenue effects.

Four such bills would erase the tax preference for heavy-duty SUVs in current depreciation rules by subjecting all SUVs with a gross weight of over 6,000 pounds to 14,000 pounds to the annual depreciation limits for passenger cars under IRC section 280F. The bills are H.R. 4384 (introduced by Representative Christopher Shays on November 17, 2005), H.R. 4409 (introduced by Representative Jack Kingston on November 18, 2005), S. 1852 (introduced by Senator Ken Salazar on October 6, 2005), and S. 2025 (introduced by Senator Evan Bayh on November 16, 2005). There are some notable differences among the proposals. H.R. 4384 includes a definition of SUV that would exclude many vans, minivans, and pickup trucks from the depreciation limits. By contrast, H.R. 4409, S. 1852, and S. 2025 appear to contain no such exclusion, but they would exempt “vehicles used in a farming business” from the depreciation limits. In addition, they would increase the limits and expand them to cover vehicles weighing between 6,000 and 14,000 pounds.

An indirect approach to lessening the tax advantages of purchasing heavy-duty SUVs for business use is offered in S. 2345 (introduced by Senator Charles Grassley on March 1, 2006). The bill would not change any of the tax preferences for these vehicles, but it would exempt so-called alternative-energy vehicles from the depreciation limits under IRC section 280F. As a result, small business owners could depreciate such vehicles faster than they can depreciate a heavy-duty SUV under current tax law. Alternative-energy vehicles include electric-powered cars, hybrid cars that run on a combination of gas and electricity, and vehicles powered by an alternative fuel such as compressed natural gas.³⁴

Yet another indirect approach is taken by H.R. 2070 (introduced by Representative Dennis Kucinich on May 4, 2005). Like S. 2345, it would not lower any current tax incentive for acquiring a heavy-duty SUV for business use. Rather, it would create a new tax incentive to buy a fuel-efficient SUV assembled in the United States, an incentive that any individual taxpayer could benefit from. The incentive is a non-refundable personal tax credit of \$4,500 for those who purchase a qualified SUV with a rated gas mileage of 45 to 54 mpg; the credit would rise to \$6,000 in the case of a qualified SUV with a rated gas mileage of 55 mpg or over.

There are no bills in the 109th Congress to alter the gas guzzler tax so that it would apply to SUVs.

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³⁴ Kurt Ritterpusch, “Finance Bill Would Increase Tax Incentives for Businesses Buying Efficient Vehicles,” *Daily Report for Executives*, Bureau of National Affairs, March 2, 2006, p. G-17.

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